

EXECUTIVE STOCK OPTION PLANS

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## BACKGROUND

The institutional and market conditions of the 1920's were ideal for the introduction of the stock option device for executives; the number of owner-managed enterprises was declining with the rise of mass production techniques; and there was a need for incentive methods of compensation for the management group. The active and rising stock markets were responsible for the interest of corporation directors and executives in stock options in this decade. In some new corporations a lack of cash for large salary payments was also a significant factor for the use of stock options. In the 1930's the income tax consideration was present only to a minor degree and was second to the attraction of a rising stock market and the absence of available cash to pay the agreed value of the executives' services.<sup>1</sup>

The pattern of individual income tax rates, established in the late 1930's, has been as significant as market price expectations in motivating the use of stock options as compensation for corporate executives, since the tax pattern consisted of steeply graduated tax rates on ordinary income and a maximum tax rate of twenty-five per cent of the gain on "capital asset" transactions. Income tax rates were pushed progressively higher to finance the cost of World War II and the uneasy peace which followed. Individuals and corporations sought legally accepted ways to minimize this tax burden. The history of

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<sup>1</sup>Daniel L. Sweeney, Accounting for Stock Options, Michigan Business Studies, Vol. 14, No. 5, 1960, p. 15.

court decisions on the taxability of the stock option as income to the optionee favored the provision of capital gains income for an executive, if he were willing to be compensated in part with a stock option agreement. The desirability of a stock option arrangement based on market price expectations could be enhanced by the prospect of receiving a substantial amount of income at comparatively low tax rates. The tax benefit made the stock option attractive to the optionee, especially to those with incomes in the higher tax rate brackets. This is the change found in the option plans of the 1940's from the earlier stock options.<sup>2</sup>

During the manpower shortage of World War II and the extensive increase in industrial productive capacity after the war, the responsibilities and required skills of key executives expanded, while income tax rates and inflation were lowering their effective disposable income. It was recognized that some form of incentive for these men was needed if they were to be encouraged to perform at high levels of achievement. The stock option was useful in this respect because it qualified both as a form of incentive compensation and as a means of minimizing taxes on the added income.<sup>3</sup>

The development of stock was slow; it was affected by the World War II Salary Stabilization Board ruling that any differential at grant or exercise date would be viewed as additional compensation subject to the Board's approval.<sup>4</sup> But the severe blow to the continued use of

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<sup>2</sup>Ibid., pp. 26-27.

<sup>3</sup>Ibid., p. 28.

<sup>4</sup>Ibid., p. 29.

stock options came in the 1945 U. S. Supreme Court decision on the Smith case (the fact in this case is that John H. Smith was employed by Western Cooperage Corporation in 1934, primarily for the purpose of effecting a contract to reorganize the Hawley Company, a subsidiary. The consideration to the parent company was a large block of the subsidiary's new stock. The parent company was to compensate Smith in part with an option to buy stock in the reorganized Hawley Company at the fair market value of this stock on the grant date, ten cents per share. Smith exercised part of the option in 1938 and the balance in 1939; the difference between option price and fair market value on exercise totaled \$152,684. The Internal Revenue Service and Tax Court held that Smith earned fully taxable income in this amount. The Ninth Circuit Court, following the earlier "proprietary interest" concept, held that there was no compensation because there was no price differential at grant of the option; and it was the option, not the stock, which must constitute compensation. The Supreme Court reversed this judgment and agreed with the Internal Revenue Service).<sup>5</sup> This decision influenced the Treasury Department to issue a regulation that henceforth the price differential at the exercise date would be taxed to the optionee as ordinary income and permitted as cost deduction by the corporation. As a result the use of options declined.

In 1950, Congress enacted a tax law creating the "restricted stock option" which later became Section 421 of the 1954 Internal

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<sup>5</sup>Ibid., p. 79.

Revenue Code. Under the tax law, the requirements for a "restricted stock option" were:

- 1) the optionee must be an employee of the taxpayer;
- 2) the option price must be at least eighty-five per cent of the fair market price at the time of grant;
- 3) the option must be non-transferable except by death;
- 4) the term of the option must not exceed ten years;
- 5) if the optionee owns directly or indirectly more than ten per cent of the voting stock of the employer corporation, the option price must be at least 110 per cent of the fair market price at the time of grant, and the option period must not exceed five years;
- 6) the option must be exercised while the option holder is still an employee or within three months after termination of employment;
- 7) after exercise of an option the stock must be held for at least two years from the date of grant and six months from the date of exercise;
- 8) if the option is granted at an option price between eighty-five and ninety-five per cent of fair market price, upon sale of such shares, the lesser of the difference between the option price and the fair market value on the date of grant or the fair market value on the disposition date is taxable at ordinary rates.<sup>6</sup>

Some early stock option plans were viewed chiefly as a means of closing the growing gap between corporate owners and managers. It was

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<sup>6</sup>William F. Connelly, Robert B. Mitchell, Federal Tax Course (Prentice Hall, Inc., 1962), p. 1313.

believed that the opportunity to acquire an ownership interest in the corporation would provide management with added incentive to enhance corporate success and progress. However, rising stock prices during the 1930's and the tax advantages of "restricted stock options" have contributed to the current view that stock options are primarily a compensation device and only secondarily a means of encouraging executives' proprietary interests.

Two features of "restricted stock options" make them attractive to executives of corporations. The opportunity to exercise options at a fixed price for as long as ten years limits the executive's risk by not requiring any commitment of capital until the market price of the stock subsequently exceeds the option price. The other attractive point is the tax treatment of "restricted stock options." Income tax is avoided when options are exercised and gains realized from selling the stock after the prescribed holding period are treated as capital gains ("restricted stock options" require that stock acquired under option plans must be held at least two years following date of grant and more than six months following date of exercise).

Since 1950 the "restricted stock option" has become a popular method of compensating corporate executives. In 1950 only 13.7 per cent of 525 companies surveyed by the AICPA mentioned the existence of stock option plans. By 1962, such plans were used by seventy-five per cent of the 600 companies then surveyed.<sup>7</sup>

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<sup>7</sup>American Institute of Certified Public Accountants, Accounting Trends and Techniques, 5th ed. and 16th ed., pp. 83 and 132.



The effectiveness of stock options as a means of executive compensation will be more apparent after reading Chrysler Corporation stock option plan example. Chrysler executives who bought and later sold Chrysler stock under stock option plans last year realized \$4.2 million in capital gains. Of this amount the executives retained \$3.2 million after payment of Federal taxes. 465,000 shares of Chrysler stock were purchased by Chrysler executives during 1963. The potential capital gains to the executives on all this stock--assuming no further rise in the price of the corporation's stock--is \$12.2 million. In addition, Chrysler executives stand to reap a special tax benefit on \$3.9 million of the gain they may realize from the optioned shares they bought last year. The \$3.9 million figure represents the difference between the option price of the stock and the actual market price at the time the option was exercised.<sup>8</sup>

The amendment to the 1954 Internal Revenue Code by the 1964 Revenue Act has set up two new classes of options qualified for special tax treatments: 1) "qualified stock options," those issued to key employees subject to much stricter rules than in the case of "restricted stock options" and 2) options issued under "employee stock purchase plans" governed by the same rules with minor modifications as the "restricted stock options."<sup>9</sup>

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<sup>8</sup>New York Times, January 15, 1964, p. 39.

<sup>9</sup>Explanation of '64 Revenue Act, Commercial Clearing House, Inc., p. 59.

## ADVANTAGES AND DISADVANTAGES OF STOCK OPTIONS

The objective of business has been characterized as the earning of maximum profit consistent with the long-term growth of the corporation. In order to bring about such an objective the corporation must first of all attain capable management. How to attain competent executives thus poses a problem. The stock option, in comparison to other methods, appears to have more attraction because it offers to the corporate executive his most promising means of building a nest egg. The desire to do so is deep and widespread, reflecting human urges for economic security and independence.<sup>10</sup>

The advantages of stock options to corporations as incentives to executives are as follows:

- 1) If a company is in financial or other difficulties, it may secure new executives for moderate annual cash payment by offering option contracts, because of the chance for large gain which such a contract offers;
- 2) Options may make it possible for corporations to secure able management which even substantial cash salaries would not attract for frequently officers desire to be large stockholders;
- 3) The stock option presents an opportunity for capital gain that links the fortunes of executives most directly with those of the corporations;

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<sup>10</sup> Henry Ford II, "Stock Options Are in the Public Interest," Harvard Business Review, July-August, 1961, pp. 45-47.

4) It is believed that the chance for gain through appreciation of stock bought under options is a definite inducement for an executive to do a constructive job.

In addition, stock options not only make it possible for a corporation to secure good management for a short period, but may perpetuate good management over a long period of years. The outstanding advantage is probably that they help hold executives who might otherwise be lured away to another corporation.<sup>11</sup>

One possible disadvantage both to the granting corporation and the executives concerned is the unfavorable reaction of some stockholders and other critics to the apparent high level of compensation which may result from gains realized through stock option plans. Some stockholders feel the use of such plans dilutes their equity, especially when unissued, rather than reacquired, shares are used. To illustrate, an executive is granted the right to subscribe at \$5 per share for 10,000 shares of stock which have a market value of \$10 per share. Assuming 90,000 shares to be outstanding, and that the right to subscribe for 10,000 shares at \$5 each is exercised while the market stands at \$10, the amount of the impairment of the rights of other stockholders may be determined as follows:

Market value of 90,000 shares @ \$10 .....	\$900,000
Additional cash invested .....	<u>50,000</u>
Value of 100,000 shares .....	<u>\$950,000</u>

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<sup>11</sup> John C. Baker, "Stock Options for Executives," Harvard Business Review, September-October, 1940, p. 120.

Diluted value of 90,000 shares (9/10ths of 950,000) .....	\$955,000
Undiluted value of 90,000 shares .....	<u>900,000</u>
Amount of impairment .....	<u>\$ 45,000</u>

Further dilution will presumably result as additional rights are exercised in subsequent years.

There is also a question as to the propriety of issuing long-term rights. Granting a long-term option gives the holders the opportunity to sit on the side lines on the basis of an investment of services and only if and when the growth of the corporation and the expansion of earning power make it clearly to his advantage to do so. The option holders, in other words, have the chance of making of a profit that is disproportionate to the risk assumed.

From the standpoint of the existing stockholders, the outstanding option rights represent a continuing threat of dilution.<sup>12</sup> From the option holders' viewpoint, the reward from options are uncertain and speculative; the executive runs the risk of having his stock fall in price after the option is exercised. What happens if the market price falls? An executive might see his gains dwindle and disappear until he finally has a net loss. Even worse, he could be in serious financial trouble if the price drop was steep enough.

Another potential stumbling block is that the SEC requires that issues of new stock to the public must be registered; if an executive's

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<sup>12</sup>William A. Paton, Corporation Accounts and Statements (New York: The Macmillan Company, 1955), 1st ed., p. 51.

option is part of an unregistered plan, he must sign a statement declaring that he is buying the stock for investment not for resale. He should beware of selling the stock thereafter. A subsequent sale not in keeping with the intent of the declaration could constitute a violation of SEC rules.<sup>13</sup>

#### BASIC FEATURES OF STOCK OPTION

There are some basic features of stock options such as the determination of which executives are to be offered option rights; the limit to be placed on the number of shares which can be optioned to any one executive; the price at which the stock is to be offered; how to finance the option price; and termination provisions, etc.

Which executives are to be offered stock option rights? Generally, the eligibility for stock option benefit is based on whether or not the executive's performance is critical to the success of the corporation. Either under "restricted stock options" or "qualified stock options," adequate consideration for granting options is more assured if the employer corporation executes a contract as part of the stock option agreement with each key employee in which, in exchange for the option, he agrees to work for the corporation for a specific minimum length of time and to forfeit the right of option if he resigns. Under present law a prerequisite to the special tax treatment is that the individual is required to be an employee of the grantor corporation, and a share

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<sup>13</sup> Richard Smyth, "Executive Compensation Gearing the Program to Today's Needs," Management Review, January, 1961, p. 76.

of stock transferred to an individual pursuant to his exercise of a restricted stock option must not be disposed of within two years from the date of the granting of the option nor within six months after the transfer of the share to the individual. In comparison, the new Section 422 (a) requires stock acquired pursuant to the exercise of a "qualified stock option" to be held for at least three years after the stock is transferred to the individual and requires that the individual be an employee of a corporation at all times beginning with the date the option is granted and ending on the day three months before the option is exercised if the special treatment is to be obtained.<sup>14</sup>

According to the survey made by McKinsey & Co. in 1961, which included seventy-two companies, options have been used in the higher echelons of management for the most part where greater individual incentive may have direct bearing on corporate profit and where salaries are high enough to make capital gains a genuine spur to effort. Six out of ten companies studied granted options only to the top half of the executive group. The same proportion granted them only to executives in the over \$30,000 bracket. However, one-fifth of all shares granted went to employees earning less than \$20,000. The percentages of option shares granted to certain pay brackets are as follows:

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<sup>14</sup> Standard Federal Tax Reports '64, Vol. 3, Commercial Clearing House, pp. 33,299-33,300.

<u>Executive in these pay brackets</u>	<u>In these %<sup>15</sup></u>
Over \$75,000	22
\$50,001-75,000	13
\$35,001-50,000	16
\$20,000-35,000	29
Under \$20,000	20

The limit to be placed on the number of shares: The conventional stock option is used with a large block of shares commensurate with the individual's position. The number of shares reported under option to any one executive varied among the individuals from 1,140 shares to 50,000 shares, based on the survey made by Baker.<sup>16</sup> Under "restricted stock options" it must be less than ten per cent of voting power. The code also permits an executive who owns more than ten per cent of voting power to participate in a "restricted stock option," provided that the option is at least 110 per cent of the fair market price of the stock at the time the option is granted and the option is limited to a five-year period. Under "qualified stock options," the law provides that the individual receiving, immediately after such option is granted, must not own stock possessing more than five per cent of the combined voting power or value of all classes of stock of the employer corporation or of its parent or subsidiary corporation; where the equity capital of the corporation is less than \$1 million, the percentage is ten per cent; where the equity capital is between \$1 million

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<sup>15</sup> McKinsey & Co., "How the Stock Options Really Work Out," Business Week, February 10, 1962, pp. 88-89.

<sup>16</sup> Baker, op. cit., p. 111.

and \$2 million, the percentage decreases proportionately down to five per cent as capital rises above \$1 million.<sup>17</sup>

The price at which the stock is to be offered: Under the "restricted stock option," to take the full tax advantage, the option price must be not less than ninety-five per cent of the current market price of the stock; the stock must not be sold within six months following date of exercise or within two years following date of grant. The option holder does not pay a cent in tax until he finally sells the stock, and it is then taxed at the long-term capital gains rate of half of his income rate up to a maximum of twenty-five per cent. Though "restricted stock option" is issued at between eighty-five and ninety-five per cent of the market price of the stock, the difference between the price of the option and market price at the time of grant is taxed as capital gain. Options issued below the eighty-five per cent mark do not qualify as "restricted stock options" and thus are taxable at the full income rate at the time of exercise. The difference between the option price and the fair market price at the time the option was granted is ordinary income. At the time the stock is sold, the balance is capital gain. In ninety-five per cent stock options the entire difference between cost and sale price is capital gain. Under the "qualified stock option," the options must be issued at 100 per cent of the market price rather than eighty-five per cent (with a special rule where the price inadvertently is set below 100 per cent). Closely

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<sup>17</sup> Standard Federal Tax Reports '64, pp. 33,299-33,300.



associated with this is the removal of the variable price stock option provision. These modifications are made to decrease the compensatory nature of the existing stock option provision and to place greater emphasis on the employee's effort to improve his corporation's business and thereby raise the price level of the stock.<sup>18</sup>

Financing the option price: To obtain funds with which to pay the option price poses a problem to executives. The corporation should set up methods to help executives pay the option price either by means of a loan or by an installment payment arrangement. The stock itself can be pledged as collateral. That would not be a "disposition" of the stock within the meaning of the statute which might violate the time limitations (restricted stock option requires that stock must be held two years following date of grant of option and more than six months following date of acquisition of stock; the new qualified stock option provides that it must be held three years from date the employee acquires the stock).

The burden on executives can also be eased somewhat by providing a long option period allowing him to exercise part of the option in installments. A revolving fund might be set up as a financing device. The corporation concern can lend the executive sufficient funds with which to exercise the first option. In due course, the executive will sell the stocks so acquired and use the money received, less the capital gain tax thereon, to exercise the second stock option. This can continue

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<sup>18</sup> Standard Federal Tax Reports '64, p. 33,295.

until all options are exercised and the employee is able to realize his net capital gain without using his own funds.<sup>19</sup>

Termination provisions: Under the "restricted stock option," the option must be exercised while the option holder is still an employee or within three months after termination of employment; the option must be exercised within ten years from the date it is granted. In addition, under "qualified stock option" the option plans must be approved by the stockholders of the granting corporation within the twelve months before or after the date the plans are adopted. It is also required that the plans so approved must indicate the aggregate number of shares which may be issued under option and employees or class of employees, eligible to receive options. The board of directors is given the authority to select the employees to which options are granted and the authority to decide upon the number of shares to be optioned to each employee. With the addition of this new condition, it seems that the benefits granted management in the case of these options are in conformity with the desires of the stockholders.<sup>20</sup>

#### SOME ARGUMENTS REGARDING THE "DATE"

It is apparent that an element of compensating may be involved when a limited number of officers and key employees are granted options to purchase stock at fixed price over extended periods. Generally,

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<sup>19</sup> John G. Powers, Prentice Hall President's Guide, p. 7041.

<sup>20</sup> Standard Federal Tax Report '64, p. 33,300.

such options are issued as inducements for continued employment and greater effort in managing the corporation in order that its success will be reflected in increased market value of the stock. The options agreement usually provides that during a specified period and upon the performance by the grantee of certain stipulated conditions, the grantee may at his own election exercise the option in accordance with its terms.

The problems involved in the accounting for any such compensation are two fold: first, measuring the value of the compensation, and second, determining the date as of which it should be valued. In considering the measure of value of such compensation Chapter 13, Section B of A.R.B. No. 43 states in part:

"...there is no such objective means for measuring the value of an option which is not transferable and is subject to such other restrictions as are usually present in options of the nature here under discussion. Although there is, from the standpoint of the grantee, a value inherent in a restricted future right to purchase shares at a price or even above the fair value of shares at the grant date, the committee believes it is impracticable to measure any value.....on the other hand, it follows in the opinion of the committee that the value to the grantee and the related cost to the corporation of a restricted right to purchase shares at a price below the fair value of the shares at the grant date may for purposes here under discussion be taken as the excess of the then fair value of the shares over

the option price."<sup>21</sup>

There is agreement that the amount of compensation cost, if any, incurred by the granting corporation is the excess of the market value over the option price.

There has been disagreement as to the date on which this excess should be measured. The three dates which are most commonly advocated are the grant date, the exercisable date, and the exercise date.

(1) Grant date: It is on this date that the option is issued to the individual. Although in many cases it may not be exercisable for several years, the fact remains that the option has been issued and represents value in the minds of both parties to the transaction. Proponents for using this date believe that it is this value which should be accounted for as compensation. (2) Exercisable date: Supporters of the exercisable date argue that it is at this point that the corporation has definitely given up something of value. Prior to this time the option could not be exercised, but now an obligation to sell stock for a specified price has been established. The difference between market and option price at this date would represent compensation. (3) Exercise date: The argument in favor of using the date the option is exercised as the measurement date is advanced on the basis that this is when it is clearly and definitely known that a cost has been incurred. Until this time no one knows whether the option will ever be exercised and if it is never exercised the corporation has not given up anything of value.

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<sup>21</sup> AICPA, Accounting Research Bulletin, No. 43, 1962, p. 123.

The AICPA in A.R.B. No. 43 states:

"...it may be assumed that if the stock option were granted as a part of an employment contract both parties had in mind a valuation of the option at the date of the contract; and accordingly value at that date should be used as the amount to be accounted for as compensation. If the options were granted as a form of supplementary compensation otherwise than as an integral part of an employment contract, the grantor is nevertheless governed in determining the option price and the number of shares by conditions then existing. It follows that it is the value of the option at that time, rather than the grantee's ultimate gain or loss on the transaction, which for accounting purpose constitutes whatever compensation the grantor intends to pay. The committee therefore concludes that in most cases, including situations where the right to exercise is conditional upon continued employment, valuation should be made of the option as of the date of grant."<sup>22</sup>

One large national public accounting company, Arthur Andersen and Company, strongly disagrees with the AICPA by adhering to the exercisable date. It has been considered that the best available measure of the value of an option is the excess of the fair market value over the option price at the time the right to exercise becomes unconditionally vested in the option holders, namely at the exercisable date. It

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<sup>22</sup>Accounting Research Bulletin, No. 43, 1962, p. 122.

is on this date that the obligation of the company to sell stock under the option at a specific price becomes definitely established for the first time. The obligation is then irrevocable, and at this point the corporation has given up something usually of a measurable value in a transaction over which it subsequently will have no control.

It has been concluded that no formal recognition is required in the accounts at the time the stock option is granted unless the unconditional right to exercise the option becomes effective at the same time. Those who advocate this grant date as a practical matter take the position that in most cases there is no significant amount of compensation because, as previously mentioned, the spread between the option and market price of the stock at that date usually is not material. It is emphasized that even though their viewpoint is different from that of many accountants, it is their opinion that there is compensation involved in stock options beyond that presently being recognized.<sup>23</sup>

In view of the controversy as to the date at which the measurement of compensation should be made, in Paton's opinion the determination of the worth of the services to be received should be made before or at the time the agreement is concluded, assuming that the terms are definite and not subject to revision during the period covered. In other words, should a corporation legitimately enter into a contract for services to be rendered without reaching a decision as to the value

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<sup>23</sup> Arthur Andersen & Co., Accounting and Reporting Problems, 2nd ed., October, 1962, pp. 77-83.

of the services, such an action is equivalent to buying a pig in a poke. However, he recognizes that circumstances may change and that the view as to the value of the services may not be the same in the future as at the time the arrangement is entered into. What he emphasizes is that:

"...the only reasonable policy is that under which the problem of determining value is squarely met at the time the parties reach an agreement. Indeed it is hard to see how the term can be settled, except by sheer guess work, prior to an evaluation."<sup>24</sup>

It seems illogical to consider a date other than the date of grant in measuring compensation cost. Once an option is granted to a particular employee, it is largely within his personal control whether the option becomes exercisable; since his continued employment is a prime corporate objective. Variation in price represents changes in the option value to him and may reflect the results of his personal speculation, but they should not affect the cost of the option to the corporation. Furthermore stockholders of the issuing corporations are likely to be unduly penalized if the compensation cost is not determined as of the date the option is granted. The principal arguments advanced by those who favor the grant date rather than the exercisable date for computing compensation under stock options are as follows:

- (1) It is illogical to select some future date as the time to

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<sup>24</sup> William A. Paton, Corporation Accounts and Statements (New York: Macmillan Company, 1933), p. 49.

compare the then market price with the option price for the purpose of retroactively determining the value of the option.

(2) So many factors affect stock prices that changes in prices between the grant date and exercisable date bear no relationship to compensation.

(3) Compensation is measured only by the value of the option as a separate property right when it is granted.

(4) It is unreasonable to assume that a corporation would contract for services without knowing the cost of such services.

However, the above arguments seem hardly to justify the current opinion that stock options have no value, except to the extent that market price at the date of grant exceeds the option price. The current practice of not recording compensation expense for stock options, although sanctioned by the AICPA, is dubious. The decision not to record any compensation expense from stock options is based on the assumption that the compensation is measured by the excess of market price over the option price at date of grant, since this difference is seldom of material amount. Actually, a stock option is part of an employment contract; it represents compensation for services rendered, thus the earning or revenue should have borne its compensation cost in compliance with the principle of matching revenue with cost. In this respect, the most reasonable approach to measuring the compensation represented by stock options is to use the excess of the market price over the option price at the date the option becomes exercisable by the option holder. At this date the corporation becomes definitely obligated



to sell the stock at the option price. At any earlier date various uncertainties such as continuance of employment exit to cloud the issue. Now the obligation is clearly established; the compensation cost stands out clearly as the difference between the option price and the prevailing market price of the stock. This difference is the corporation's cost of performing its contract to issue shares at the option price. Any changes in market price between the date when the option is first exercisable and some later date when the executive chooses to exercise the option may be important to the employee but are not relevant to the corporation's interpretation of compensation cost. The option is no longer subject to control by the corporation; delay in exercising the option is a speculative activity by the option holder.

#### ACCOUNTING TREATMENT OF STOCK OPTION

Under generally accepted accounting principles the cost of the compensation inherent in stock options is not being recorded. This situation exists because industry, supported by the AICPA and the SEC, has considered the element of compensation to be measured only by difference between the market price and the option price at the date of grant of the option. This difference generally is not recognized at all since in almost every case it is immaterial in amount. Most options now outstanding are "restricted stock options" as defined in the Internal Revenue Code; accordingly the option prices usually are based on income tax considerations and are not less than eighty-five per cent of the fair market value at the date of grant, with many cases approximately ninety-five per cent.

When compensation is involved, its amount as determined at the date of grant should be charged to income in the period during which the services are rendered and, when the period is not specifically set forth in the agreement, the apportionment should be reasonable in the light of the attendant circumstances. The offset to the income charge should be set up in an account similar to that covering subscriptions to capital stock; this account should be reduced by appropriate credits to the capital accounts as the options are exercised.<sup>25</sup>

To illustrate:

July 1, 1960. The board of directors of a corporation adopted a stock option plan which gave some of the personnel the right to purchase stated numbers of shares of \$10 par value common stock at an established price. The options are nontransferable and they cannot be exercised (1) until two years after the date of grant and (2) unless the holder continues in the employment of the corporation. Options not exercised within one year after becoming exercisable lapse.

August 1, 1960. Options for 12,000 shares are granted. The options established the purchase price of the shares at \$20 per share. Today's market price is \$22 per share.

August 1, 1962. The options may be exercised by the holders still in the corporation's employment because the conditions stated above have been satisfied.

June 1, 1963. The options are exercised and 12,000 shares of

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<sup>25</sup>Norman J. Lenhart and Philip L. Defliese, Montgomery's Auditing (New York: Ronald Press Company, 1957), 8th ed., p. 329.

stock are acquired by the option holders for \$20 per share. Today's price is \$30.

Market price per share on date of grant.....	\$ 22
Option price.....	<u>20</u>
Excess of market price over option price.....	\$ 2
Number of shares issued.....	<u>12,000</u>
Total executive compensation expense.....	<u>\$24,000</u>

Since the executives must work for two years after the date of issuance of the stock options to obtain the compensation, that period seems to be an appropriate one over which to charge the compensation to operations. Assuming that the corporation is on a calendar-year basis, the spread of the \$24,000 over the two-year period is as follows:

<u>Dec. 31, 1960</u>	Executive compensation expense	\$5,000
	Accumulated credit under stock option	\$5,000
<u>Dec. 31, 1961</u>	Executive compensation expense	\$12,000
	Accumulated credit under stock option	\$12,000
<u>Aug. 1, 1962</u>	Executive compensation expense	\$7,000
	Accumulated credit under stock option	\$7,000
<u>June 1, 1963</u>	Cash	\$240,000
	Accumulated credit under stock option	24,000
	Common stock	\$120,000
	Paid-in-surplus	144,000

The credit balance at any time in the "accumulated credit under stock option" is a part of stockholders' equity and is somewhat similar to a stock subscribed account. How would the credit balance be dealt

with? Should the resulting credit be considered as (1) a correction of the prior year's net income (as it turned out, no additional compensation was distributed to the employees and hence the prior year's charges for additional compensation were unnecessary and resulted in understating the net income figures) or as (2) additional paid-in-capital. The services were performed and, if the estimated value of the services was reasonable and determined in good faith, in effect, additional capital was contributed to the corporation. Based on Paton's opinion, "the fact of the acquisition of valuable services through a combination of salary and investment transaction is not altered by the failure of the option holder to complete the investment process, neither the validity of the estimate of the value of the services nor the amount of the services received is affected by the lapsing of the rights." It follows, "...the credit covering the amount invested is a capital item and should be allowed to stand as part of the total capital received."<sup>26</sup>

The alternative to the stock option problem for the entries on the accounting records is to use the exercisable date approach. According to this approach, the cost of the compensation (the difference between the option price and the market price on the exercisable date) should be charged to income and credited to capital surplus. This cost should be accrued on an estimated basis over the period between the grant date and the exercisable date since it matches cost with services; also it presumably provides for the compensation cost accruing over

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<sup>26</sup> Paton, op. cit., pp. 52-53.

this period on the basis of current market prices or estimates with a credit to a reserve account. The final cost would be determined at the exercisable date and the reserve closed out to capital surplus at that time. If the compensation is all recognized at the exercisable date, it would ordinarily be charged to income at that time, but any material amounts applicable to prior years might be charged to earned surplus as prior year adjustments.

The weakness in current practice lies in the assumption that compensation is limited to the spread between the market price and option price at the date of grant. It results in substantial understatement of executive compensation cost. As mentioned earlier, a stock option is related to an employment contract: it represents compensation for services rendered and, in some cases, a most important part of the total compensation. Therefore, it is more reasonable to use the exercisable date approach rather than the grant date approach.

#### FULL DISCLOSURE OF STOCK OPTIONS

It is expected that in a dynamic and constantly changing environment there are always some areas where common modes of thoughts and business practices have not evolved to the point where it is possible to identify generally accepted uniform standards. Stock option is but one example. The professional approach in these unsettled areas has been to require supplemental disclosure, through footnotes or other means which would enable the readers to place the results reported in perspective.

The SEC requires full disclosure of the particulars of the plan, the options outstanding, and a description of the accounting followed by the registrant with respect to the options. Rule 3-20 (d) of Regulation S-X requires the following information to be given in financial statements filed with SEC as to capital stock optioned to officers and employees:

"(1) A brief description of the terms of each option arrangement shall be given, including i) the title and amount of securities subject to option; ii) the years during which the options were granted; and iii) the years during which the optionees became or will become entitled to exercise the options. (2) State i) the number of shares under option at the balance sheet date, and the option price and the fair value thereof, per share and in total, at the dates the options were granted; ii) the number of shares with respect to which options became exercisable during the period and the option price and the fair value thereof, per share and in total, at the dates the options became exercisable; and iii) the number of shares with respect to which options were exercised during the period and the option price and the fair value thereof, per share and in total, at the dates the options were exercised. The required information may be summarized as appropriate with respect to each of these categories. (3) State the basis of accounting for such option arrangements and the amount of charges, if any,

reflected in income with respect thereto."<sup>27</sup>

The New York Stock Exchange requires corporations whose securities are listed on the Exchange to include the following information with respect to reporting on stock options:

"The corporation will disclose in its annual report to shareholders, for the year covered by the report, 1) the number of shares of its stock issuable under outstanding options at the beginning of the year; separate totals of changes in the number of shares of its stock under option resulting from issuance, exercise, expiration, or cancellation of option; and the number of shares issuable under outstanding options at the close of the year, 2) the number of unoptioned shares available at the beginning and at the close of the year for the granting of options under an option plan, and 3) any changes in the exercise price of outstanding options, through cancellation and reissuance or otherwise, except price changes resulting from the normal operation of anti-dilution provisions of the options."<sup>28</sup>

The AICPA in A.R.B. No. 43, states as follows:

"...in connection with financial statements, disclosure should be made as to status of the option or plan at the end of the period of report, including the number of shares under option, the

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<sup>27</sup> Rappaport, SEC (Securities and Exchange Commission), Accounting Practice and Procedure (New York: Ronald Press Co., 1956), p. 263.

<sup>28</sup> Lenhart and Defliese, op. cit., p. 426.

option price, and the number of shares as to which options were exercisable. As to options exercised during the period, disclosure should be made of the number of shares involved and the option price thereof."<sup>29</sup>

The SEC's disclosure requirement enables the readers to compute the compensation cost, if any, which would be recorded using any of three dates--the grant date, the exercisable date, or exercise date. It seems that the reporting standards as presently accepted are inadequate; the standards of disclosure of the SEC appear in this respect to provide more of the relevant data needed for analysis. An underlying accounting problem that has not yet been solved in practice relates to general standards of supplementary disclosure. It is thus the current problem of the profession to formulate such standards.

#### SUMMARY AND CONCLUSIONS

Doubtless, stock options have provided a fruitful means of attracting and keeping key corporate personnel. The experience of giant companies such as Sears, Roebuck & Co., Ford Motor Company and the Kroger Co., proclaim the benefits of stock options. Stock options in general have many favorable features. They help to focus executive attention on the long-term good of the corporation; they can provide recipients with a valuable hedge against inflation; and they can help an executive build an estate. At the same time stock options for execu-

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<sup>29</sup> A.R.B., No. 43, p. 124.



tives are criticized. Shareholders frequently claim that equity is diluted when unissued shares of stock are used in an option plan; many executives lack the cash necessary to exercise their options; the rewards anticipated from stock options are uncertain and speculative; the executive also runs the risk of having his stock fall in price after the option is exercised.

The 1964 Revenue Act makes extensive changes in the stock option provisions of the Internal Revenue Code. The different features of "qualified stock option" are as follows:

- (1) The period over which the stock must be held has been increased from two years to three years. This is designed to give assurance that the employees actually are acquiring a "stake" in the business.
- (2) The maximum period of time over which an option may be outstanding has been reduced from ten years to five years. The purpose of the provision is to encourage the acquisition of a proprietary interest in the business as quickly as possible.
- (3) The options must be issued at 100 per cent of the market value rather than eighty-five per cent (with a special rule where the price inadvertently is set below 100 per cent). Closely associated with this also is the removal of variable price stock option provisions.
- (4) Provisions have been added to limit the extent to which new options may be exercised where old options previously were issued, but had become less attractive than a new option because of a decline in the market price of the stock in the interval between the issuance of

the two. Existing law already limits the resetting of options below the original price of issue where the market price of the stock has declined.

(5) Stockholders' approval is required for stock option plans.

(6) The bill also provides that stock options generally are not to be made available to employees with stockholdings of more than five per cent. It is thought unnecessary to provide employees who are substantial stockholders with any incentive to improve the business since they already have a substantial stake in successful operation.

Problems in connection with stock option arises primarily because of the inadequacy of the related accounting. The most elementary requirement is that operating costs include compensation to individuals. As mentioned earlier, costs do not today include the compensation element of stock options. The AICPA and the SEC have considered the element of compensation to be measured only by the difference between the market price and the option price at the date of grant of the option. The difference is not recognized at all, since it is immaterial in amount. The weakness in current practice lies in the assumption that compensation is limited to the spread between the market price and option price at the date of grant. To emphasize the fallacy of this line of reasoning, assume that a corporation adopts an option plan under which the option price is set at 100 per cent of market price at the date of grant. Could any one seriously contend that such an option is worthless? In other words, stock options represent compensation for services rendered. Under the principle of matching revenue with cost, the earnings of the

corporation which has an option plan should bear its compensation cost.

The accounting profession and SEC did not have the foresight to prescribe the most elementary principle of accounting. As a result stock option, which is a desirable method of compensation, may be cast in an undesirable shadow of question. Accordingly, stock option has been strongly influenced by its tax treatment. As the tax treatment changed, the accounting treatment should have done likewise. Now it is the time for the accounting profession to make over-all review of accounting treatment concerning stock option in order to establish sound accounting principles.

It seems to me desirable to use the exercisable date rather than the grant date in view of the amendment of the 1964 Revenue Act. Options after 1964 are going to be "qualified stock options." The cost of compensation seems to me more properly measured by the difference between the option price and market price at the exercisable date than at the date of grant. This cost, which is the difference between the option price and the market price at the exercisable date, should be charged to income and credited to capital surplus. As to whether this cost should be accrued on an estimated basis over the period between the grant date and the exercisable date or all charged to income at the latter date, the best matching costs and revenues would be obtained by providing for the compensation cost accruing over this period on the basis of current market prices or estimates with a credit to a reserve account. The final cost would be determined at the exercisable date and the reserve

closed out to capital surplus at that time. If the compensation is all recognized at the exercisable date, it would ordinarily be charged to income at that time, but any material amounts applicable to prior years might be charged to earned surplus as prior year adjustments.

Despite the restrictions imposed by the 1964 Act, stock options should continue to play a significant role in corporate executive compensation programs. It seems probable, however, that in the future stock option plans will receive less emphasis than before since the new law may, in many cases, make it more difficult for executives to realize the fruits of their efforts through stock options. Moreover, the reduction of individual income rates in the 1964 Revenue Act removes some of the incentive which previously existed for limiting salaries and bonuses in favor of larger stock option benefits. For these reasons, it seems likely that the future trend will be toward more generous bonus and deferred compensation plans. Stock option plans should be continued but probably in reduced proportions.

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EXECUTIVE STOCK OPTION PLANS

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AN ABSTRACT OF A MASTER'S REPORT

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## ABSTRACT

The "restricted stock option" has been widely adopted by corporations as a means of compensating corporate executives. The law which governs the "restricted stock option" has two important features: one, the opportunity to exercise option at a fixed price for as long as ten years, limits the executive's risk by not requiring any commitment of capital until the market price of the stock subsequently exceeds the option price; the other is the avoidance of income tax when options are exercised and capital gain treatment on gain realized from selling the stock after the prescribed holding period.

The amendment to the 1954 Internal Revenue Code by the 1964 Revenue Act has set up a new class of "qualified stock option," which is subject to much stricter rules than in the case of "restricted stock option." Mainly, the period over which stock must be held has been increased to three years; the maximum period of time over which an option may be outstanding has been reduced from ten years to five years; the option must be issued at 100 per cent of the market value rather than eighty-five per cent at the date of grant as compared with the "restricted stock option."

The problem involved in accounting for stock options is to decide the date as of which compensation cost should be valued. There are three dates which are commonly advocated--the grant date, the exercisable date, and the exercise date. Under generally accepted accounting principles the compensation cost arising from stock options has not been



recorded. This is based on the assumption that the compensation is limited to the spread between the market price and option price at the date of grant. The difference is not recognized at all since it is an immaterial amount. However, this line of reasoning is doubtful. As a matter of fact, a stock option is associated with an employment contract; it represents compensation cost for the service rendered, therefore the earnings or revenue should have borne related compensation cost. The most reasonable approach to measuring the compensation represented by stock options is to use the exercisable date. At this date the corporation becomes definitely obligated to sell the stock at the option price. At any earlier date various uncertainties such as continuance of employment existed to cloud the issue. Now the obligation is clearly established; the compensation cost stands out clearly as the difference between the option price and the prevailing market price of the stock. This difference is the corporation's cost of performing its contract to issue shares at the option price.

In view of the tax changes related to stock options, it is the time for the profession to make an over-all review of the accounting treatment regarding stock options so as to set up sound accounting principles.

Since the new law in many aspects makes it more difficult for executives to realize the fruits of their efforts through stock options, it is expected that stock option plans in the future will receive less emphasis than before.